State aid in the European Union and Croatia

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Chapter 5

STATE AID IN THE EUROPEAN UNION AND CROATIA

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Bad government, like bad luck, kills off growth.
William Easterly, 2002, p. 217

ABSTRACT

EU policy on the state aid granted by member countries to their national economies is based on a general presumption that state aid is incompatible with the running of the single market. The European Commission has the right to ban any state aid that distorts market competition by extending privileges to certain firms and sectors (or by favouring certain firms and sectors. The EU instruction is that national state aid should be reduced and that it be reoriented towards horizontal objectives, for only then are they assisting all firms and sectors alike. In the Republic of Croatia government expenditure to promote the economy is considerable and mainly directed towards certain sectors: shipbuilding, tourism, transport and agriculture. It is to be expected that in order to comply with EU policy Croatia will have both to reduce the extent of state aid and redirect it towards horizontal objectives.

Key words:
EU, Croatia, state aid

INTRODUCTION

The purpose of this paper is to show what Croatia should do in order to draw closer to the EU in its state aid policy. The remainder of the paper is organized as follows. In the next section, the policy of the EU in the area of state aid is laid out; section three gives a survey of state aid in Croatia, while the fourth section sums up by stating the current situation of state aid in Croatia and what needs to be done to approach the position of the EU. It should be noted that the paper is but an initial attempt to draw up a review of state aid in Croatia as there are almost no papers that discuss this matter. Research has been hampered by the lack of published information about the kinds, recipients and amounts of state aid. Precisely because the lack of proper figures, in this phase of the research it was very difficult in a short period to give a reliable quantification of the amount of total state aid in Croatia. That is why we provide only a review of state aid according to the agencies in charge of granting it, in an attempt to delineate the sectoral distribution. Increased transparency in the monitoring of state aid urged by the EU in all of the candidate countries will certainly facilitate easier calculation of the extent of total state aid. Transparency of the state aid system will facilitate monitoring and sectoral analysis, and will free government policy concerning state aid from lobbyist pressures.

ANALYSIS OF THE ACCESSION CONDITIONS FOR THE NEW EU MEMBERS

State aid - reasons for and against

State aid is a form of state intervention[i], the aim of which is to encourage some economic activity, sector or firm. It distorts competition, because it discriminates between those who receive aid and those who do not (Commission of the European Commission, 2002). What does distortion of competition mean? The market criterion in the judgement of whether some aid distorts the competition is: competition is distorted if no participant in the market wishes to invest the same amount under the same conditions in a firm that the state supports (Lavadas and Mendrinou, 1999). That is, the state, through its aid, redirects the flow of investment into industrial activities and firms that private investors do not invest in (Adams and Klein, 1985; Schultze, 1986; Krugman, 1986).

Traditional state intervention is commonly focussed on to the state selecting those industrial activities or firms that are considered to need assistance. These are either the future "winners", that is, those activities and firms expected to attain high rates of growth, or loss-making undertakings and firms which use state aid for survival and rehabilitation. This kind of state intervention is premised upon government possessing the analytical capacity to determine, better than the market, the appropriate economic structure, to select the sectors and firms that are potential winners, determine which loss-makers should be rescued, and determine the measures through which this should be carried out.

But experience has demonstrated that this kind of traditional approach is inefficient and does not lead to restructuring and growth. The government has proven itself incapable in many ways. It has not known how to pick a winning sector, it has not known when to stop assistance, i.e., when a certain activity is capable of operating on its own, and with its frequently wrongly chosen measures has brought many distortions into the economy thus reducing economic efficiency. Under pressure from various lobbies the network of state intervention has become increasingly complex, and the state administration ever more corruptible. When some intervention has become settled, there is a risk that the government will become influenced by interest groups who lobby, successfully, to keep the aid, although this is no longer economically justified.[ii] Apart from that, there are always new candidates who would find state aid quite handy. For why should agriculture be subsidised and not tourism nor the food industry, which are linked with agriculture? Under the pressure of interest groups, state aid is hard to remove, new aid is granted, and the vicious circle is hard to break.

In addition, state intervention leads to unfair competition between subsidised and non-subsidised firms. The lower prices that can be charged by subsidised firms, and which are not the result of increased quality or productivity, lead to well-performing but nonsubsidised firms but having to charge higher product prices being squeezed out of the market. At the same time a growing state aid creates an increasing pressure on the government budget, which in turn results in higher taxes and undermines the fiscal sustainability. Ultimately state aid has to be financed out of taxes, and for this reason, all taxpayers bear the cost of them. Although they face lower prices for subsidised goods, consumers ultimately, through increased tax rates, nevertheless pay the full price of such goods.

Although because of the many negative consequences of aid the state should be very circumspect with its policy, it is also true that state aid sometimes can stimulate growth. Thus the EU is not an opponent of state aid, but thinks it should be directed only into areas where market does not perform, i.e., where there are examples of market failure (Commission of the European Community, 2000). The emphasis is placed on the complementarity of government and market, and it is considered that markets supported by the state are needed to attain successful economic growth. Table 1 gives examples of market failures, and the manner in which they can be palliated by aid.

Table 1. Market failures

Name of market failure	Example of market failure	Most common form of state aid
Public goods	Lightouses, street lighting, public radio and television	Direct provision of the service by the state
Merit good	Programs for vaccination, cultural services and-elementary education	Subsidising or total financing
Economies of scale	Monopoly or oligopoly markets	Aid to firms entering the market
Externalities, positive and negative	Research and developement; pollution	Subsidising; taxation regulation
Incomplete, imperfect or asymmetric informations	SMEs find it hard to obtain finance	Subsidised interest, guarantees, information centres
Rigidity of the labour market	Minimal wage	Reduction of contribution, subsidised wage
Reduced mobility of factors	Work and capital move with difficulty into undeveloped	Improving the quality of infrastructure regions
Difficult adjustements to market subsidizing	Firm or sector that needs to be restructured	Help in exiting he market
Foreign subsidising	Assistance to domestic industry to protect it from-the effects of subsidies granted by other countries	Subsidies, negotiations in the WTO

Source: European Commission, 1999; 25

But for the use of state aid to be justified, it is not enough to determine the existence of a market failure. It is also necessary to give reasoned proof that the public sector can solve the particular problem better than the private sector (Sandmo, 2002). Also very important is the proper selection of the form of state aid. For all possible forms of state aid, such as subsidies, tax exemptions, soft loans and others have their advantages and drawbacks, and can have very different impacts on the economic efficiency of a given sector, the economy as a whole, and the welfare of the citizens. Before applying a given form of state aid, it is necessary to compare all the benefits and costs (direct and indirect) that it entails.

EU policy with respect to state aid[iii]

Of the numerous regional groupings, only the EU in an explicit manner determines the control of the state aid of its members (European Commission, 1999). State aid undermines the principle of unbiased and free competition, and amounts to a limitation of the functioning and development of the single EU market. For this reason the European Community Treaty set up a system of rules allowing members to use state aid only in exceptional cases.

Article 87(1) of the EC Treaty basically says that state aid and the single market *are not* compatible because state aid granted to a firm or an activity affects trade among the member states. More precisely, this article states that “all aid that is given by member state in any form that distorts competition because by its partiality it gives an advantage to given firms or products and thus has an effect on the flows of trade among the members is not compatible with the single market.” If the regulations of the countries were really to be based only on this one article, then the member countries of the EU would not have much room for intervention to support given regions or national economies. However Articles 87(2) and (3) solve this problem, clearly stating which aid measures may be permitted if they do not adversely affect the common market. From the length of the schedule of such state measures it is clear that a wide space is left for aid at the level of individual countries and the whole of the EU. Aid that is allowed in Article 87(2) relates to aid of a social character, on condition that it does not result in discrimination of products with respect to a national or regional origin; aid that makes good damage caused by natural disasters or other unpredictable events and aid meant for those regions of Germany that were hit by the division of the country. Article 87(3) expands the space for intervention even further by listing aid that can be considered compatible with the common market, for example aid that promotes the economic development of areas in which the standard of living is atypically low or in which unemployment is very high; aid that makes possible the conclusion of projects that are of common European interest or those that mitigate serious distortions in a national or regional economy; aid that makes possible the development of certain economic activities or areas and that does not have a deleterious effect on commerce among the member countries; aid that promotes the conservation of the cultural heritage and the environment, and all other kinds of aid that the Council of Europe can vote in with a qualified majority.

Considering the number and heterogeneity of the kinds of aid allowed it is clear that the basic motivation for the control of state aid at the EU level is not that it should be done away with or banned rather that unnecessary distortion of market competition within the EU be diminished. This is achieved by monitoring and regulating aid and defining and adjusting the conditions in which member states can provide specific structural and/or regional aid. Article 88 gives the duty and right to control state aid to the European Commission. For this reason, member states must inform the European Commission about national aid policies, and the Commission's remit is to determine whether they are compatible with the objectives of the European Community Agreement. Of course, the Commission cannot control every kind of instrument that national members can apply and that affect or might affect corporate behaviour. Control relates only to those measures that meet all the criteria stated in Article 87(1)[iv], i.e., that a given measure of aid:

- means a transfer of state resources,
- results in an economic advantage that the firm or product would otherwise not have,
- implies selectivity, which means that the application of the measure changes the relationship among firms or products,
- has an effect on the competition and trade between the member countries. Aid is bound to modify the degree of competitiveness.

Accordingly, the general criterion of a permissible measure is that it is in line with the obligations of the Agreement and that it is limited to the smallest possible measure necessary to achieve the aims of the intervention. This actually means that the objective of every sectoral aid, to be acceptable, must be the attainment of the long-term sustainability of the sector (which is achieved by settling structural problems or reducing capacity). If the aid that some state gives does not meet these criteria, the European Commission has the *duty and the right to forbid* such aid.

These measures became the subject of an active policy of reducing state aid. Thus at meetings of the European Council in Stockholm in 2001 and in Barcelona in 2002, member states were required to reduce state aid (defined in Article 87(1)) as proportion of GDP and to redirect state aid to the support of horizontal objectives.[v] Horizontal objectives prevent the possibility of regional or sectoral favouritism and are concentrated on the removal of market failure and can be considered to distort competition less. Typical horizontal aid is directed to research and development, environmental protection, the development of SMEs, commerce, energy saving, restructuring of firms, employment, sustained training and so on. The most recent report of the European Commission about trends in aid in the EU (European Commission, 2002) shows that the members on the whole are adhering to the Stockholm and Barcelona instructions, but that there are still great disparities among them (Table 2).

An aid category that is very often used is what is called *ad hoc* aid. All aid not foreseen by the existing instruments has an *ad hoc* character. Such aids are usually used for restructuring and bailing out firms. They are characterised by the principle of minimal amounts and the principle of non-recurrence, i.e., they are given only once and never again. Most of this kind of aid goes to industry, particularly to the shipbuilding and steel sectors (more than 50%), but a considerable number of such aids are directed towards financial services and air transport.

From this table it can be seen that in the EU state aid came on average to 0.99%[vi] of GDP in 2000, and that it fell during the 1996-2000 period. At the same time the proportion of horizontal aid rose, and in 2000 it came to 47% of total aid.

Most aid goes on transportation, mining, agriculture and fisheries, and within the help to manufacturing industry, on shipbuilding and steel production. The most frequent form in which aid was given to industry and services was the subsidy (EU average 63%) and tax exemptions (EU average 25%). However, there are considerable differences in the member countries; for instance, Luxembourg, Finland and the UK give their support to manufacturing industry and services mainly via subsidies (95.91 or 96%), while Ireland uses these much less often (only 19%), making much more use, however, of tax exemptions (74%).

Table 2. Basic data concerning trends in state aid in EU member states

	State aid as % of GDP (2000)	Trends in aid as % of GDP (1996-2001)[1]	Horizontal as % of overall aid (2000)[2]	Trends in the proportion of horizontal aid as % of overall aid [1,2]
EU	0.99	-0.25	47	12.2
Belgium	1.34	-0.11	77	3.0
Denmark	1.23	+0.15	83	0.7
Germany	1.23	-0.26	46	14.4
Greece	0.89	-0.40	8	4.4
Spain	0.99	-0.20	42	7.4
Finland	1.44	-0.30	71	1.3
France	1.13	-0.24	42	9.1
Ireland	1.20	+0.34	55	12.9
Italy	0.92	-0.47	33	11.8
Luxembourg	1.24	+0.18	47	9.9
Netherlands	0.98	+0.09	75	2.6
Austria	0.97	-0.18	58	-1.5
Portugal	1.18	-0.44	38	7.4
Sweden	0.75	-0.11	61	3.0
UK	0.46	-0.17	60	4.1

[1] *Change of percentage between annual average for the period 1996-1998 and 1998-2000*
[2] *Total aid reduced by that for agriculture, fisheries and transportation.*

Source: Commission of the EC, 2002

ANALYSIS OF STATE AID IN CROATIA

EU and state aid in Croatia

Through signing the Stabilisation and Association Agreement (SAA) Croatia, among the many obligations, took on obligations about state aid. Thus Article 70 of the SAA stated that Croatia had to set up an independent operational body for the monitoring and implementation of state aid. The work of this body would be to draw attention to every item of state aid that would distort market competition by favouring some firms or products. This body will approve programmes of state aid and order the return of aid given illegally. It should also draw up a comprehensive list of all aid programmes, and bring these programmes into compliance with EU criteria in a period of at the most four years from the time the SAA comes into force. There should be a legal base for such activities in a state aid law. According to the plan of the implementation of the SAA, the work of adopting this law, the foundation of the body charged with state aid matters and the drawing up of the list of existing state aid should be done during 2001 and 2002. The objective of the EU demands made on Croatia is to increase the transparency of the system of state aid and to see that state aid is funnelled in line with the aims agreed on among the member states of the EU.

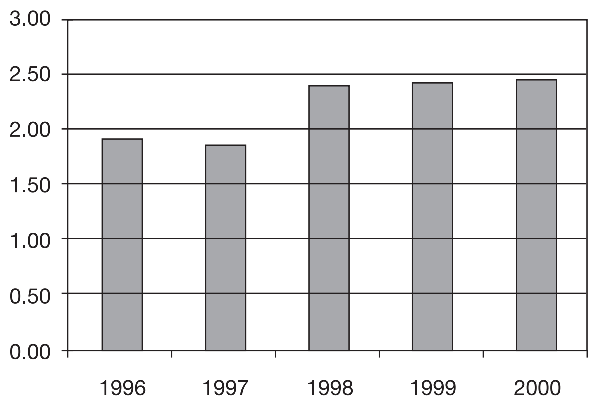
A review of state aid in Croatia

This chapter will endeavour to give a brief overview of state aid in Croatia. This is only a survey of a very complex phenomenon, and not any kind of quantification of the total amount of state aid. For information about state aid is not yet kept in any single place, and has to be assembled from numerous sources, from Official Gazette, the papers, the Web pages of individual ministries, or be obtained from personal sources. This makes it more difficult to provide in-depth analysis or evaluation of it. We hope that when the actions relating to state aid that the EU has imposed as an obligation on Croatia are carried out this problem will be solved, and that the review of such aid will be more transparent.

The review of state aid has been done according to those in charge of it; there are direct subsidies from the national Budget, favourable loans and guarantees that are given via the Croatian Bank for Reconstruction and Development (known as HBOR), the Ministry for Trades and SMEs (MOMSP) and the Croatian Guarantee Agency (HGA); subsidised employment via the Croatian Employment Service (HZZ/CES) and tax incentives that are given pursuant to the tax laws. We have also put available information about corporate rehabilitation into the review, which is also a considerable form of state aid in Croatia.

Apart from these state aids, which have been being allocated for quite some time, certain statutory approaches for the stimulation of the economy have been passed that have not yet come fully into force. Thus in July 2000 the Investment Incentives Law was passed, the aim of which, via various measures (subsidies, tax and customs incentives and so on) was to stimulate the development of the economy. During 2001, the following regional funds were set up: the Development and Employment Fund and the Regional Development Fund, the aim of which is also to encourage the development of the economy. The newly founded Croatian Small Business Agency will also deal with the stimulation of development, while support to Croatian exporters and domestic and foreign investors will be supplied by the Promotion of Export and Investment Agency set up in September 2002.

Figure 1. Direct subsidies as % of GDP



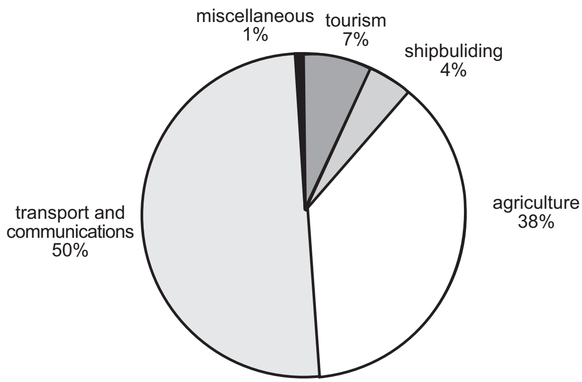
Source: MF Republic of Croatia, 2000 and internal data of Ministry of Finance

Direct subsidies from the national Budget

In 2000, 3.8 billion kuna in current subsidies were allocated from the national Budget, coming to 2.4% of GDP (Ministry of Finance, 2001). Subsidies recorded a jump in 1998, when they grew from 1.86% GDP to 2.38%. In the period after 1998, they mainly remained at the level of about 2.4% of GDP (Fig. 1).

It should be emphasised that subsidies are also allotted at a local level as well, and not only from the national Budget. Thus in 1999, at the level of general consolidated government, subsidies worth 3.9 billion kuna were given, but from the national Budget 3.4 billion kuna (Ministry of Finance, 2001). The difference between the two sums is made up of subsidies granted at lower levels of government. Thus in 1999 about 500 million kuna worth of local subsidies were allotted, i.e., about 13% of national level subsidies.

Figure 2. Direct subsidies as % of GDP



Source: MF Republic of Croatia, 2001 and internal data of Ministry of Finance

In 2000, state subsidies were mainly allocated to transport and communications (50% of overall subsidies), agriculture (38%), tourism (7%) and shipbuilding (4%) (Fig. 2). There are no great differences here between Croatia and the EU average. The biggest single beneficiaries are Croatian Railways, subsidised to the tune of 1,276 million kuna, agriculture with 1,233 million kuna, Jadrolinija Rijeka with 166 million kuna, BINA Istria[vii] with 288 million kuna, and firms in the tourist industry with 266 million kuna.

Favourable loans and guarantees of HBOR, HGA and the Ministry of Trades and SMEs (MOMSP)

Croatian Bank for Reconstruction and Development (HBOR)

The fundamental activity of HBOR comprises programmes of loans to firms and programmes of providing guarantees. With these programmes, HBOR takes part in the reconstruction and development of the economy and the infrastructure, incentives to SMEs and financing and giving security for the export operations of the Croatian economy.

According to HBOR's Annual Report for 2000, 1.6 billion kuna were spent on loan programmes, and 2.5 billion kuna for guarantees, i.e., a total of 4.1 billion kuna. About 90% of the total activity of HBOR was accounted for by sectoral aid, and about 10% by horizontal measures, this mainly for incentives to small and medium sized enterprises.[viii]

The interest charged on loans made available by HBOR via the commercial banks are lower than the market rates for the end users. Via its Interest Rate Decision, made by the Supervisory Board, HBOR sets the interest rates for its loan programmes. On 26 February 2002 the Supervisory Board of HBOR made an Interest Rate Decision according to which the rates for end users ranged from 3% a year (for users with direct war damage) to 7.5% for all other users. At the same time the average interest rates of the commercial banks, for long term kuna denominated loans to the corporate sector without a foreign currency clause were 8.69% p.a. (Croatian National Bank, 2002). Thus the interest rates for HBOR loans are much lower than the interest rates on the money market. Via HBOR, then, the state allocates more favourable loans and gives incentives for the development of business, mainly tourism and shipbuilding, and partially the development of SMEs.

Croatian Guarantee Agency (HGA)

A relatively small guarantee business is done via the HGA, which provides support for the development of enterprise. Aid relates to small and medium size firms, sole traders, tradesmen, co-operatives, individual farmers and freelance operators. According to the HGA Annual Report (HGA, 2001), in 2000, 604 guarantees for loans amounting to 115 million kuna were made, and 3.9 million kuna worth of non-returnable aid was given. Most guarantees were made according to the Programme for Areas of Special Concern of the Republic of Croatia, that is, mainly for the regional development of SMEs.

Ministry for Trades and SMEs

The Ministry for Trades and SMEs (MOMSP) mainly hands out loans to existing small enterprises or beginners, and for the development of new technologies, export and tourism, and for restructuring. Loans from the MOMSP programme are also approved and implemented via the commercial banks and local self-government units. During 2001, 2,264 loans were made, to a total amount of 1.1 billion kuna, which is twice the amount loaned in 2000. In 2001, the loans were made with an interest rate that ranged from 5.5 to 7.5% (Jutarnji list, 2002). Thus, like loans from HBOR, loans from MOMSP are a very favourable way for businesses to borrow money, and the difference between the subsidised interest and market interest rates is a direct subsidy to the user of the loan.

Employment incentive

During 2002, the government adopted a Programme for Employment Incentives (NN 21/2002), which contains six sub-programmes:

- A - *From University to Job* – for persons with a degree younger than 27 who took their degree within the average time for the institution.
- B - *From Classroom to Workshop* – for skilled and highly skilled workers without work experience who are completing secondary vocational schools.
- C - *By Studying to Work for All* – oriented to education for specific labour market requirements.
- D - *By Experience to Profit* – for older persons with experience.
- E - *Opportunities for Us Too* – the employment of disable persons and persons who are hard to employ.
- F - *Jobs for the Defenders* – hiring Croatian veterans and their wives and children if they are unemployed.

The institution in charge of these programmes is the CES. A programme is carried out via the joint financing of hiring, the CES subsidising for the employers some of the costs for the newly employed and thus making labour cheaper. It is expected that during 2002, 14,029 people will be employed via these programmes, and that 179 million kuna will be spent (DZS, internal figures).

Tax incentives

The Profit Tax Law (NN 127/2000) allows taxation incentives that have the form of indirect state aid to firms.

Incentives to regional development

Taxpayers who carry out some activity in an area of special national concern pay profit tax at a rate that might be 25, 50 or 75% of the prescribed rate of profit tax, i.e., 20%. In these areas, then, profit tax comes to 5, 10 or 15%. Taxpayers in the area of the city of Vukovar are totally exempted from the payment of profit tax for a period of five years from the start of their activity, and after that have to pay profit tax at 25% of the prescribed rate.

Incentives in free zones

Free zone users pay profit tax at a rate of 50% of the prescribed rate. If a zone user invests 1,000,000 kuna in the free zone, in the next five years it will not pay profit tax at all. If the free zone is in the area of the Vukovar and Srijem County, it will not pay tax for five years from start-up, and then will pay profit tax at 25% of the prescribed rate.

Investment incentives

Privileged profit tax rates depend on the amount of the investment and the number of employees in the firm. The opportunities for taking advantage of privileged rates, which only new firms can have, are given in Table 3.

Table 3. Tax privileges for investments

Amount of investement	Preferential rate	Period of use of the preferential rate	Employment obligation
At least 10 milllion kuna	7%	10 years from the beginning of the investment	At least 30 employees
More than 20 million kuna	3%	10 years from the beginning of the investment	At least 50 employees
More than 60 milllion kuna	0%	10 years from the beginning of the investment	At least 75 employees

Employment incentives

The tax base can additionally be reduced by the amount of pay and employer's contributions for new employees during the first year from their hiring. In this manner, these wages can be deducted twice: first as an expenditure while the profit is being calculated, and the second time as a reduction of the then determined base for profit tax.

Uncollected taxes

Uncollected taxes are usually considered an indirect subsidy. Tax that is not collected and is written off by the government or is collected in a reduced amount after a settlement is made with the taxpayer constitutes indirect financial aid to the tax defaulter. Apart from this, such measures distort competition, because it puts regular taxpayers into an unequal position as against the taxpayer whose debt is excused. Croatia has a law in force called the Collection of Due but Unpaid Taxes, Customs Duties, Contributions and Government [State] Guarantees Law (NN 117/2001 and NN 95/2002). Taxpayers whose debt was incurred up to 31 December 2000 have the right to come to a settlement with the government, and pay their debts in one of these ways: a one-time payment with a reduction, transferring claims, ceding real estate, rescheduling claims and ceding claims or multilateral compensation. The total claims with respect to uncollected debts to the state come to more than 21 billion kuna. Within the time limit allowed by the law, that is, until 23 January 2002, more than 35,000 debtors (firms and tradesmen) reported a total of 5.33 billion kuna, or about a quarter of the total debt to the state (Poslovni tjednik, 2002a). This tax debt could be met by the debtors by a settlement with the state via one of the models anticipated. Thus the state will collect part of the debt, and the rest will become an indirect subsidy to these tax defaulters. The remainder of the debt will probably never be collected, and in its full amount can be considered an indirect state subsidy.

Corporate rehabilitation

Company bailouts are usually done by cancellation of debts or by the transformation of them into equity. The EU classifies debt conversion too as one of the forms of state aid because without such aid, loss-making firms would not be able to survive on the market. In the Republic of Croatia too such a form of help to loss-making firms is frequently used, and the government has often made decisions attempting to rehabilitate firms it owns. This has primarily concerned shipbuilding and the agribusiness firms. Thus in February 2001 the government adopted its Provisional Measure for the consolidation of companies in agriculture in which the government authorised the line ministries to write off their claims, to reschedule them or turn them into equity. According to government estimates, the debts of the big agricultural companies came to about 2.2 billion kuna (Jutarnji list, 2001).

In addition, after 1997, when the government of Croatia had adopted its Decision to bail out certain companies (NN, 118/97), a rescue process was started up in five shipyards. Through this decision, creditors were supposed to swap their undisputed due claims for shares, or equity in firms owned by the Croatian Privatisation Fund, or the Republic of Croatia. Since the government was dissatisfied with the modest results of the rescue operation carried out, in August 2002 it adopted financial measures to help the shipbuilding industry that came to a total of 2.8 billion kuna. These measures related to taking over the repayment of loans to the national Budget and the write-off of debts to the Ministry of Finance relating to payments made for guarantees issued. The programme of these financial measures relates to the period up to 2008. The government also obligated itself to subsidise the building of ships in the amount of 10% of the sale price of a ship (Vlada RH, 2002).

Investment Incentives Law

In July 2002, the Investment Incentives Law was passed (NN, 73/2000), allowing a number of incentive measures to be carried out: the leasing of real estate owned by the Republic of Croatia, assistance in job creation, assistance in training and further training, tax breaks[ix] and customs privileges (non-payment of customs duties for the import of equipment). These incentives are available only to new firms for investments that come to at least 4 million kuna, domestic firms having priorities in obtaining such privileges. During the two years of the implementation of the law, only 9 firms obtained the right to these incentives, in the amount of 803 million kuna (of which, 646 million kuna relates to the firm Metro Cash & Carry) (Poslovni tjednik, 2002b). But in 2002, an amendment to the law was prepared, and it was in the parliamentary procedure during the autumn.

Development incentives via the development funds

At the end of 2001 laws were passed to found two development funds: the Development and Employment Fund and the Regional Development Fund of the Republic of Croatia (NN, 107/2001). The funds are mainly financed from the Budget, and with revenue from privatisation; they can also borrow short-term up to at most 25% of the annual financial plan, and, pursuant to a government decision, even more than that if resources from privatisation have not accrued. Their basic objective is to encourage development and employment. However, these funds cannot be said to have started working properly yet.

The Regional Development Fund

The work of this fund is to encourage the development of war-torn areas, areas of sparse population, areas of special national concern, the islands, the hilly and mountain areas, border areas, areas with structural problems, areas that have a GDP lower than 65% of the national average, and other areas. The resources of the Fund in these areas are meant for the implementation of infrastructure and economic projects. The projects are chosen according to competitive bidding announced by the Fund, with counties and their projects taking part. A prior selection is carried out by a county for its own region, based on cost-benefit analyses for infrastructure projects, and on certain other criteria for business projects; profitability, export orientation, environmental impact, being based on domestic resources, and employment of the local population. The final choice of projects is made by the Fund's Board of Management. The selected projects are financed with loans the conditions of which the Board also sets, but which have to be more favourable than those on the money market. According to the Fund's Financial Plan for 2002, it is expected that 611 million kuna will be invested in regional development (NN, 26/2002).

Development and Employment Fund

The work of this fund is directed to the encouragement of trades, SMEs, to providing support during hiring, the encouragement of new technologies and export programmes, support for county programmes, help in the foundation of business and development centres, free and industrial zones, giving state-owned real estate for development purposes and for the reconstruction of facilities demolished in the war. After the announcement of invitations for bidding by the Fund, the choice of projects is carried out by the counties, which then recommend them to the Board of the Fund, which finally takes them on. The projects are financed with loans not worse than those on the capital market, by subsidising interest rates, purchase of bonds, assignment of real estate and equipment that the Republic of Croatia has at its disposal and with non-refundable aid. Projects that create new jobs, that are viable on the market, export-oriented, that use domestic resources and that meet environment protection regulations will have the priority in the allotment of resources. The Financial Plan of the Fund for 2002 envisages development incentive resources to the tune of 3 billion kuna (NN, 26/2002).

Croatian Small Business Agency and the Promotion of Export and Investment Agency

During 2002, two agencies were founded that have not fully started working as yet. Thus the Incentives for the Development of Small Business Law (NN, 29/2002) founded the Croatian Small Business Agency, the Managing Board of which was appointed in September 2002 (NN, 103/2002). The objective of the Agency is to provide incentives for the development of small business by a series of measures, from favourable loans, guarantees, aid to increase employment, and the provision of information to entrepreneurs. Resources for the work of the Agency are provided from the Budget, domestic and foreign funds and the banks.

In September 2002 the Promotion of Export and Investment Agency was founded (NN, 102/2002), the business of which is mainly to supply information support to Croatian exporters and to local and foreign investors; this should start coming on-stream by the end of 2002.

The definition of areas in which adjustments to EU conditions are required

Although the Croatian government has taken seriously the preparations for Croatia's association with and joining the EU, in the area of state aid there is still a lot of work to do. This relates to bringing the legal and institutional base into compliance, and also to an analysis of economic arguments in line with European understandings of the role of state aid. It is not in question that Croatia will have to change its way of thinking about state intervention. In the past the state made decisions about this independently. With EU entry, the final word about most such interventions will go to the European Commission. And although the Commission is very easy-going in giving its acceptance of aid in some member country, the fact is that on paper at least, the policy is based on the assumption that state aid distorts market competition and reduces efficiency. For this reason no single member can make autonomous decisions about the majority of the rules and instruments for giving aid. This, then, means that Croatia will have to adjust its objectives according to which aim is given to products, producers and regions. The hardest task will certainly to be to redirect state aid away from individual economic sectors and to horizontal targets.

In the area of the instruments that are used to implement aid there will also have to be adjustments, although not as drastic as those in relation to the actual targets. The introduction of differing tax regimes to attract new investors or restructure the economy will increasingly be considered an unacceptable form of state aid, and member countries are advised against the use of differential rates of taxation.

CONCLUSIONS AND RECOMMENDATIONS

State aid works against the principle of unbiased and free competition, and means a restriction in the functioning and development of the single EU market. For this reason the EC Agreement set up a system of rules according to which member states are allowed to give state aid only in exceptional circumstances. State aid that distorts market competition can be vetoed by the European Commission. The general EU recommendation is that member states reduce the extent of state aid up to 2003, and after that direct it to horizontal targets. This EU preference with respect to state aid will in the future very largely determine Croatian policy too with respect to state aid.

In order to be able to evaluate more easily the situation of state aid in Croatia with respect to EU demands, we tried above to systematise state aid according to the kind of division applied in the EU. All aids that are used in Croatia, then, have been classified into three groups: sectoral, horizontal and regional. It should be said that the amounts in Table 4 cannot be aggregated in order to obtain the total amount of all forms of state aid (subsidies, favourable loans, guarantees, tax breaks and so on). there are four reasons for this. Firstly, we do not have enough of the required information to calculate the amount of state aid for each measure. For example, the amount of loans given by HBOR to shipbuilding cannot entirely be considered state aid. State aid is only the difference between the HBOR rate and the market interest rate[x]. Secondly, the division of state aid into three groups means there is some overlapping: some of the measures are found into two groups. Thus HBOR loans for SMEs are included one time in horizontal measures, and a second time in regional measures, where they refer to loans to SMEs in areas of special national concern or on the islands.

Table 4. Sectoral, horizontal and regional state aid in the Republic of Croatia

	Measure	Source/in charge	Amount (mil kuna)	Year
Sectoral aid				
tourism	subsidies favourable loans	national Budget HBOR	266 359	2000 2000
shipbuilding	subsidies favourable loans guarantees rescue operation	national Budget HBOR HBOR government programme	163 697 2,503 2,800	2000 2000 2000 2002
transport and communications	subsidies	national Budget	1,907	2000
agriculture	subsidies rescue operation	national Budget government	1,433 2,200	2000 2001
restructuring and so on	subsidies favourable loans	national Budget HBOR	30 12	2000 2000
exports	favourable loans	HBOR	180	2000
new firms for investments larger than 10 million kuna	reduced profit tax rate	Profit tax law		
Tax payers	settlements about unpayed tax	Collection of due but not collected tax law	21,000	2000
Horizontal aid				
SMEs	favourable loans guarantees subsidies favourable loans	HBOR HGA HGA MOMSP	181 115 4 1,128	2000 2000 2000 2001
infrastructure	subsidies favourable loans	national Budget HBOR	0.3 70	2000 2000
enterprise improvements	subsidies favourable loans	national Budget HBOR	2.4 143	2000 2000
employement incentives	subsidies reduction of profit tax for newly employed persons	Profit tax law	178	2002

Regional aid				
areas of special national concern, islands	favourable loans	HBOR	89	2000
areas of special national concern, Vukovar, free zones	reduction of profit tax	Profit tax law		

Source: as in the text

Thirdly, data relate to different years. Fourthly, the list of state aid is not complete – it does not include the work of the Development and Employment Fund, the Regional Development Fund, measures according to the Investment Incentives Law, the Croatian Small Business Agency and the Promotion of Export and Investment Agency, because at the present their total activity in providing business incentives is nugatory.

However, irrespective of the restrictions given in the table, it is clear that most state aid in the Republic of Croatia is directed to the development of individual sectors, mainly to tourism, shipbuilding, transportation and agriculture. In 2000, 3.8 billion kuna or 99% of total subsidies from the national Budget were directed to these purposes alone, as were 3.6 billion kuna in HBOR loans and guarantees, or 86% of this bank's total activities. Additional stimuli to individual firms and sectors can be expected from the more extensive future activities of the Development and Employment Fund and the Regional Development Fund, as well as the more thorough implementation of the Investment Incentives Law.

Relatively few state resources went for horizontal purposes. Most marked was the work of MOMSP, HBOR and HGA, which hand out loans and guarantees for the development of SMEs. MOMSP is the most active in this respect, via which 1.1 billion kuna went in 2001 for loans to SMEs, the major state activity within horizontal measures. SMEs are considered to find it hard to obtain loans, because the banks do not have adequate information on the basis of which to estimate their probable performance. At the same time, SMEs find it more difficult to access information about new technologies and markets. For this reason state aid in correcting this market failure is considered a justified horizontal measure. During 2002, considerably extended CES activity in subsidising new employment is anticipated.

Regional measures are mainly related to the stimulation of the development of areas of special national concern with tax breaks, favourable loans and HBOR guarantees. With greater activity from the newly-founded Regional Development Fund, the development of a large number of undeveloped regions in Croatia will be assisted. Regulations about incentives to island and mountain/hill country development are in force, but there are still quite a lot of bureaucratic obstacles in the way of their proper implementation.

Finally, attention should be drawn to the fact that the amount of state aid in Croatia is large. Only subsidies from the national budget in 2000 came to 2.4% of GDP. For the same of comparison, all forms of state aid in the same year in EU countries came to 0.99% of GDP (ranging between 0.46 to 1.44% in the individual countries), and the demand has been made that they be additionally reduced by 2003. Only subsidies from the national Budget in Croatia are two and a half times as great as total state aid (subsidies, assisted loans, tax incentives and so on) in EU countries. It is thus to be expected that the EU will insist that Croatia cuts its spending on state aid and redirects what remains to horizontal targets at the expense of sectoral and ad hoc aid. An EU demand that Croatia found a body to monitor and implement state aid would increase the transparency of the system of state aid, and would make the monitoring and analysis of, as well as state policy with respect to, state aid easier. Croatia will, then, still be able to give state aid, but will gradually have to bring it into line with EU requirements. The first step in this process is the implementation of the provisions of the SAA that should be accomplished during 2002, thus making the aid system much more transparent.

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[i] *In this paper the term state aid means a form of state intervention, while the term subsidy has a narrower meaning and indicates only one form of aid, that is, a direct aid from the budget.*

[ii] *The statement of Mr. Božidar Pankretić, Minister of Agriculture , is quite telling: "Why should someone sow wheat at all if he can't get subsidies?" (Statement for Vjesnik, printed in Jutarnji list, 30 June 2002 p. 10).*

[iii] *This part is largely based on European Commission, 1999, and Commission of the European Community, 2002.*

[iv] *For a more precise description of these criteria see the European Commission, 2002.*

[v] *All sectors and firms are helped equally by horizontal measures, while sector- and region- specific measures assist only selected firms and regions.*

[vi] *It should be noted that this amount covers aid that individual countries give their own economies, and not aid that is given from the EU budget. The amount, then, does not include aid to agriculture that the Union gives as part of the CAP, but only aid that individual members give to their own agriculture. It is this information that is of interest in*

this paper, since it is necessary to determine what Croatia needs to do in order to approach the policy of national aid that has been agreed on by EU countries.

[vii] *BINA Istria is a firm set up for the financing, construction and management of the Istrian Y – semi-motorway complex.*

[viii] *Some of this aid went to areas of special national concern, and has a regional character.*

[ix] *Described in Tax incentives.*

[x] *For a more detailed calculation of this difference, more figures would be required, and they could not be collected in a short period of time.*

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